

Private Letter Ruling: Petition of insurance company to use alternative apportionment method granted.

April 1, 2002

Dear:

This is in response to your letter dated October 15, 2001, in which you request a Private Letter Ruling on behalf of Z Life Insurance Company of STATE. The Private Letter Ruling will bind the Department only with respect to Z Life Insurance Company of STATE for the issue or issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that neither Z Life Insurance Company of STATE nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

The facts and analysis as you have presented them in your letter are as follows:

Today, my company, Z Life Insurance Company of STATE, filed its 2000 Form IL-1120 along with our payment for a total net replacement and net income tax of \$232,660. The **sole** reason for the entire tax in 2000 derives from a **single** \$133,832 annuity premium written for an Illinois resident as part of an estate settlement purchase of seven annuities (of which six of the beneficiaries are not Illinois residents).

The result occurred because in 2000 my company wrote only \$1,099,095 everywhere (due to an overly competitive environment for annuities) and this single Illinois annuity represented slightly over 12% of our overall volume. When this apportionment factor is applied to our considerable investment earnings, it results in the \$232,660 tax.

We are filing this "Petition for Alternative Allocation or Apportionment" under Regulation 100.3390 because obviously a **174% tax on revenue** is inappropriate and unfair. What we propose as an alternative is to pay 2000 net replacement and net income tax applied to the entire \$133,832 annuity premium revenue as income which of course totally disregards any reduction for annuity payments, reserves and other expenses associated with issuing this annuity. We have attached an amended return with this petition reflecting this proposed alternative.

This alternative would result in a tax of \$9,538 for 2000 (which is 7.3% of the \$133,832 revenue less the standard exemption and credit for replacement tax), plus any interest and penalties due. In addition, we would accept that our Illinois net operating loss carryforward is totally eliminated in 2000. We would not apply any net operating loss carryforward from 2000 and prior into future years. While this approach results in taxation of an amount which I believe overstates the economic benefit of this single \$133,832 annuity issued in 2000 to an Illinois resident, it is our fault for not recognizing this tax quirk until a couple of days ago.

We recognize that it is within your discretion to reject this petition, although we hope that would not occur. We acknowledge that the statutory apportionment of insurance company income on the basis of calendar year premium income is probably appropriate for most situations. When applied in our circumstance, however, it results in an absurd outcome.

A Form IL-1120-X amended return was enclosed with your letter. Consistent with the request in your letter, the refund claim apportioned \$133,832 in business income to Illinois and requested a refund of the reduction in Illinois income tax resulting from the decrease in the amount of business income apportioned to Illinois.

In telephone conversations between MR.A, Controller of Z Life Insurance Company of STATE, and Paul Caselton, Deputy General Counsel – Income Tax of the Department of Revenue, it was established that the taxpayer sells annuities and long-term life insurance policies, often for a single premium.

According to its federal income tax returns (provided by MR.A), the taxpayer had gross premiums of \$675,836,741 in 1999 and \$1,099,095 in 2000. However, although there were virtually no premiums received in 2000, the taxpayer had a considerable number of policies and annuities in force during 2000. The 2000 federal income tax return reports deductions of over \$29 million in death benefits and over \$18 million for increases in reserves for that year. Most of the life insurance company gross income was from investment income, reported as over \$113 million for 2000. The taxpayer also deducted nearly \$34 million in interest expense and over \$2 million in policy acquisition expenses.

MR.A also provided the Department with a schedule showing that, as of December 31, 2000, Z Life Insurance Company of STATE had accrued reserves of \$923,393,644, of which \$1,632,426, or 0.1768%, were for annuitants who were residents of Illinois.

Ruling

Section 304(f) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/201 *et seq.*) provides:

If the allocation and apportionment provisions of subsections (a) through (e) do not fairly represent the extent of a person's business activity in this State, the person may petition for, or the Director may require, in respect of all or any part of the person's business activity, if reasonable:

- (1) Separate accounting;
- (2) The exclusion of any one or more factors;
- (3) The inclusion of one or more additional factors which will fairly represent the person's business activities in this State; or
- (4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

86 Ill. Adm. Code Section 100.3390(e)(2) provides that a petition for relief under Section 304(f) of the IITA may be filed as an attachment to an amended return, as was done in the present case.

Section 304(b) of the IITA provides that:

business income of an insurance company for a taxable year shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is the direct

premiums written for insurance upon property or risk in this State, and the denominator of which is the direct premiums written for insurance upon property or risk everywhere.

The purpose of this provision is to apportion the business income of an insurance company according to the location of the risks insured, which, in the case of a life insurance company, would be the location of the individuals whose lives are insured. The direct premiums written for such risks is the measure of the relative amount of risks within and without Illinois.

In the present case, the use of direct premiums written in 2000 as the measure of the relative amount of risks within and without Illinois clearly fails to fairly represent the extent of the business activity of Z Life Insurance Company of STATE in Illinois. The direct premiums written in 2000 completely fail to take into account risks associated with long-term policies and annuities for which no payment is made in 2000, but which are in effect during that year, and for which reserves must be maintained and investment income earned in 2000 in order to provide for eventual payment. As measured by the reserves accrued against such risks, only 0.1768% of the total risks of Z Life Insurance Company of STATE were located in Illinois. Accordingly, the direct premiums measure of risk, which would apportion 12.1766% of business income to Illinois, produces a grossly distorted measure of the business activity of Z Life Insurance Company of STATE in Illinois.

Apportioning 0.1768% of the business income of Z Life Insurance Company of STATE to Illinois would effectuate a more equitable apportionment. Accordingly, Z Life Insurance Company of STATE should apportion to Illinois the fraction of its business income equal to the reserves accrued at the end of 2000 for risks in Illinois divided by the total reserves accrued at the end of 2000.

Grant of Section 304(f) Petition

The petition of Z Life Insurance Company of STATE under Section 304(f) of the IITA to use the alternative apportionment formula described in this ruling is hereby granted, and Z Life Insurance Company may use that apportionment formula for Illinois income tax returns for its taxable year ending December 31, 2000, and for returns due (including extensions) 120 days after October 15, 2001, the date the petition was filed.

Using this apportionment method will entitle Z Life Insurance Company of STATE to a refund greater than that shown on the amended return filed with the petition. In particular, the use of this apportionment method will not cause Z Life Insurance Company of STATE to lose the benefit of any Illinois net loss carryforward deduction to which it is otherwise entitled. Accordingly, Z Life Insurance Company of STATE should file an amended return using the apportionment method described in this ruling in order to claim the appropriate refund. A copy of this letter should be attached to the amended return and to any subsequent return on which this apportionment method is used. After the amended return is filed using the apportionment method described in this ruling, Z Life Insurance Company of STATE must continue to use that formula for its 2000 tax year and for all subsequent tax years until use another formula is permitted or required by the Department of Revenue.

This ruling applies only to Z Life Insurance Company of STATE as a result of distortion caused by the statutory apportionment formula when applied to its separate-company business activities. This ruling shall not apply for any period in which Z Life Insurance Company of STATE is a member of a unitary business group required to use the combined apportionment method under Section 304(e) of the IITA. The facts upon which this ruling are based are subject to review by the Department during

the course of any audit, investigation or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

Sincerely,

Glen L. Bower
Director of Revenue